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CONTRACTUAL CORPORATE GOVERNANCE

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Abstract
Companies have the choice to deviate from their national corporate governance standards by opting into another system. They can do so via contractual devices – such as cross-border mergers and acquisitions, (re)incorporations, and cross-listings – which enable firms to choose their preferred level of investor protection and regulation. This paper reviews these three main contractual governance devices, their effect on value, and whether their adoption by firms induces a *race to the bottom* or a *race to the top*. Indeed, firms may opt for less shareholder-orientation or investor protection (*shareholder-expropriation hypothesis*) rather than for more stringent rules that require firms to focus on shareholder value (*bonding hypothesis*).

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1. Introduction

Companies have the choice to deviate from their national corporate governance standards by (partially) opting into another system. They can do so via contractual devices – such as cross-border mergers and acquisitions, (re)incorporations, and cross-listings – which enable firms to choose their preferred level of investor protection and regulation. This paper reviews these three main contractual corporate governance devices, their effect on value, and whether their adoption by firms induces a *race to the bottom* or a *race to the top*. Indeed, firms may opt for less shareholder-orientation or investor protection (*shareholder-expropriation hypothesis*) rather than for more stringent rules that require firms to focus on shareholder value (*bonding hypothesis*).

However, convergence via contractual corporate governance may only be an issue of marginal interest if a process of formal convergence of the various corporate governance systems is already under way. Let us first turn to the evidence on such convergence. Hansmann and Kraakman (2001) argue in their paper entitled 'The end of history for corporate law' that differences in ownership structures across countries do not necessitate differences in national corporate governance regulation. They claim that publicly held organizations are most effectively run when regulation assures that management act in the interest of shareholders and also prevents minority shareholder expropriation by large shareholders. To this respect, Hansmann and Kraakman believe that Anglo-American regulation and corporate governance are superior and they predict a global convergence of corporate governance practices towards this model. They predict that companies that do not adopt a shareholder-oriented approach will be punished by the capital market through an increased cost of capital. This Darwinian theory predicts that only one form of corporate governance will survive.

Although there are many plausible arguments in favour of formal convergence, there seems to be some resistance to this survival of the fittest in practice. First, the differences in ownership and control between Anglo-American countries, Continental Europe and Japan are large and are relatively stable over time. Roe (1996) and Bebchuk and Roe (2002) argue that once a corporate governance system is in place, incumbent interest will tend to preserve that system unless and until major inefficiencies or other disruptions arise. Moreover, it will often be efficient not to incur switching costs. Given these continuing differences, the agency costs prevailing in various systems differ as well and these differences call for different structures and goals in corporate governance regulation. For example, the complementarity between control and legal systems is obvious in a country with strong ownership concentration: here, an important task of corporate law is to protect minority shareholders. La Porta et al. (2000) investigate the differences in investor protection and their relation with control concentration across the world and attribute significant differences in capacities to protect outside investors to legal origin. Based on the rent-protection theory[1], Bebchuk (1999). Bebchuk and Roe (2002), Coffee (1999), and Roe (1996) explain the existence of (lasting) differences in corporate governance. First, different ownership structures exist, because of the different private benefits of control that can be captured in different countries. Second, convergence of corporate governance regulation is limited because current regulation is path-dependent on the financial/legal history. Further, Gugler et al. (2004) predict that in addition full convergence of governance rules will never occur because of countries' economic heritage. Bebchuk and Roe's (1999) s*tructure driven path dependency* theory states that current ownership structures result from the initial ones which are moulded by the initial corporate legislation as well as the economical, political, social, and cultural environment. In other words, countries with different initial starting points arrive at different corporate ownership structures. If an organization has adopted a particular ownership structure, changing it would lead to organizational inefficiencies. For instance, such a change would affect the functioning of regulatory agencies and financial institutions. Another reason for hysteresis is network externalities: a firm's most efficient ownership structure is affected by the ownership structure of other firms and the economic environment. Also, a change in the ownership structure may have significant impacts for some stakeholders. For instance, such a change may reduce the private benefits of certain stakeholders who may try to resist the change. There is also r*ule driven path dependency*: the initial ownership structures influence the current ones through their effect on the evolution of corporate law. The first source of rule driven path dependency is economic efficiency. A country initially adopts laws and regulation designed to maximize efficiency given the ownership structures in place at the time. Another source of path dependency is the influence of interest groups. Bebchuck and Roe (1999) argue that the initial set of corporate rules is put in place by specific interest groups to serve their preferences. These interest groups may benefit from a particular ownership structure via the private benefits it generates. Roe (2003a) suggests another source which is politics. If a government is not supportive of e.g. diffuse ownership such a structure will not survive. Cultural differences across countries represent another source of path dependency as they may impede reform. Stulz and Williamson (2003) and Licht (2005) investigate the effect of culture on corporate law and the corporate governance system of a country. They conclude that there is a significant relation between a country's culture, and shareholder voting rights and creditor rights. Roe (2003a, 2005a) argues that social norms are another source. Indeed, the social norms of a company are strongly aligned with the social norms of its country. For instance, managers in Europe tend to take into account the social welfare when making corporate decisions which implies less focus on shareholder value maximisation. This increases the managerial agency costs and leads to more concentrated ownership.

[1] The rent-seeking or rent-protection theory explains why countries stick to a certain type of corporate governance regulation while this may still be economically inefficient. The reason is that specific types of shareholders can extract rents (private benefits) from firms given the corporate governance environment. Consequently, they will attempt to impede changes which may reduce their private benefits of control.

While far-reaching convergence may be difficult to achieve, there has indeed been some convergence on specific issues across the two main corporate governance regimes: the Anglo-American and Continental European regimes. Goergen, Martynova and Renneboog (2005) show that the takeover regulation in Continental Europe has changed significantly over the past decade and has brought Continental Europe closer to the UK. For example, the use of voting caps and multiple voting rights (although non-voting shares can still be issued in most European countries) is no longer permitted. Goergen et al. conclude that there is a gradual convergence towards the Anglo-Saxon model. Still, they point out that regulatory changes may have different outcomes in the different systems and that the evidence of convergence does not necessarily imply that the systems are converging towards a single corporate governance system.

Wójick (2006) also shows evidence of governance convergence. He compares the corporate governance ratings (related to shareholder rights and duties of directors) for the largest European companies for 2000 and 2003 and interprets the increase in the governance ratings across almost all his sample firms as evidence of a shift towards the US-system.[2] There are also several other drivers of corporate governance convergence such as the harmonization of listing requirements and financial accounting standards and practices. For example, the European Commission has decided that, as of 2005, all companies listed on a stock exchange in the EU need to comply with the International Financial Accounting Standards (IFRS).

We conclude that some formal harmonization of corporate governance has arisen over the past 2 decades in terms of e.g. accounting rules, takeover regulation, listing requirements, investors protection. There are still strong differences not only between the main governance regimes (the Anglo-American system on the one hand, and the Continental European and Japanese one on the other) but also on the country level within each main system. Given the scepticism of many academics such as Gilson (2000) about strong formal convergence of governance regulation, we now turn to the role of the three main contractual corporate governance mechanism: cross-border takeovers, (re)incorporations and cross-listings.

2. Cross-border mergers and acquisitions

2.1. Changes in corporate governance through cross-border takeovers.

The main hypothesis on cross-border M&As involving bidding firms with stronger investor protection than that of their targets is that such deals earn positive returns. This valuation effect is expected to be reflected in both the target and bidder announcement returns. In detail, international law prescribes that in a cross-border full acquisition, the target firm adopts the nationality of the acquirer (Bris and Cabolis, 2008, and Bris et al. 2008). Hence, the target firm adopts the accounting standards, disclosure practices,

[2] Cernat (2004) is more sceptical and believes that the Anglo-Saxon system is unlikely to work in Europe due to fundamental national differences. Moreover, the EU has failed to create a single European corporate governance system over the last 30 years. Bolton and Röell (2002) agree that European countries prefer their own set of governance rules and will therefore prevent the EU from pushing through one unified set of European corporate governance standards.

and governance structures of the acquiring firm (Rossi and Volpin, 2004). Martynova and Renneboog (2008a) expect the synergies created by such cross-border mergers to be an increasing function of the difference in the quality of corporate governance between the bidder and the target. They call this phenomenon the *positive spillover effect* of corporate governance.

The question then arises as to what may happen if the bidder offers worse investor protection than the target. From a legal point of view, the merged firm will end up with the bidder's corporate governance. The decrease in corporate governance quality (the *negative spillover effect*) may be reflected at the takeover announcement in the returns to the bidder and the target. Martynova and Renneboog (2008a) also formulate an alternative hypothesis to the negative spillover hypothesis. A bidder from a country with inferior governance standards may use the acquisition to bond himself to the stricter investor protection regulation of the target. If this *bootstrapping hypothesis* is valid, cross-border takeovers initiated by bidders with poor investor protection may thus create governance-based synergies which will be reflected in higher announcement returns to the bidder and target. So what are the factors that determine the quality of corporate governance regulation? The literature proposes the following factors: shareholder protection, creditor protection, accounting standards, and law enforcement. In addition, Martynova and Renneboog (2008a) suggest minority shareholder protection, which is important in countries where most companies have a large shareholder. Barca and Becht (2001) show that this is the case for most continental European countries.

a) (Minority) shareholder protection

The degree of shareholder protection is determined not only by the corporate law applicable to the shareholders of a company (Bris and Cabolis, 2008) or by the codes of good corporate governance practice (so called soft law) enshrined in corporate law (e.g. legal requirement to comply-or-explain), but also by the listing requirements of the stock exchange where a firm is listed. As mentioned above, if the corporate governance standards of the bidder's country are low, there may be a negative spillover effect. However, the bidder may use private contracting or bootstrapping to adopt the corporate governance practices of the target. In this context it is important to note that, while this bootstrapping/bonding is *voluntary* in a full cross-border acquisition, in case of a partial acquisition[3] the bidder has to honour the corporate governance rules that the target is subject to. More specifically, according to the *extraterritoriality* principle in international law, the host state is entitled to subject a foreign-owned subsidiary to its corporate law by reason of domicile of the subsidiary (Muchlinski, 1997). For instance, a French subsidiary which is not fully owned by its US parent is subject to French law. Thus, a partially acquired target is subject to the local corporate governance regulation and – in case it is listed – also to the local listing rules. From the bidder's perspective, the minimum requirement is thus to comply with the

[3] A partial acquisition consists of the bidder acquiring a stake of less than 100% in the target.

corporate governance regulation of the target's country for any decision involving the target's assets and governance.[4]

b) Creditor rights

Corporate governance spillovers may also affect creditors as they impact on the agency costs of debt. However, La Porta et al. (2000) argue that there are limitations to the functional spillover of creditor rights, because corporate assets remain under the jurisdiction of the country where they are physically located. In case of bankruptcy, this *territoriality principle* implies that each local court is in charge of the assets located in its jurisdiction and distributes them only to those creditors who present their claims (Felsenfeld, 2000). Conversely, Renneboog and Szilagyi (2006) argue that it is not always the case that a firm's assets remain under the jurisdiction of the country where these assets are located. As a result, the complexities of administering cross-border insolvencies led to the creation of the Model Law on Cross-Border Insolvency by the United Nations Commission for International Trade Law (UNCITRAL) in 1997. In order to reduce legal uncertainty, the Model Law puts a single jurisdiction in charge of the insolvency proceedings. The law aims at preventing firms from concealing assets or from transferring them to foreign jurisdictions and ensuring the fair treatment of all creditors. The main proceedings are held in the country where the firm's centre of main interests is, and any concurrent proceedings are considered secondary proceedings. The Model Law proposes a modified form of the *universality principle* rather than that of territoriality.[5]

One possible effect of such jurisdictional co-operation is that it may encourage creditors to arbitrage their firm's exposure to multiple jurisdictions. This phenomenon is known as *jurisdiction (or forum) shopping* (Renneboog and Szilagyi, 2006). If a firm becomes financially distressed, creditors may race against management and each other to find a creditor-friendly jurisdiction to strengthen their legal position and to obtain maximum satisfaction for their claims. Cross-border M&As can clearly increase the scope for jurisdiction shopping, thereby further enhancing creditor protection spillovers.[6] How jurisdictional co-operation can encourage jurisdiction shopping is best demonstrated by the framework adopted by the

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[4] In some cases, it not clear which firm is the acquirer and which one is the target. Bris and Cabolis (2007) provide such examples. For instance, German incorporation is likely to be chosen in a cross-border takeover transaction involving a German firm as the transfer of control of a German company to a foreign firm is prohibited by law. As a result, the foreign bidder has to create a German corporate shell. Tax issues may also be of great importance as the exchange of shares triggers different tax liabilities across countries. Consequently, in some M&As the largest party is not the surviving entity as its country has the less attractive tax regime.

[5] The Model Law is based on previous international agreements on cross-border insolvency, including the Nordic Bankruptcy Convention of 1933, the Montevideo and Bustamente Conventions in force in much of South America and the Convention on Insolvency Proceedings of the European Union (which became the European Insolvency Regulation of 2000). The US did not have such a formal agreement in place until 2005 when it included the Model Law into its bankruptcy code as Chapter 15. However, the US had already applied a modified form of universality, such that it claimed worldwide jurisdiction over firms incorporated in the US, but was also prepared to co-operate with and possibly recognize the rulings of concurrent proceedings abroad to prevent the unequal treatment of foreign creditors (Lechner, 2002).

[6] Forum shopping by creditors is a well-known phenomenon even within the US and explains the popularity of the specialized bankruptcy courts of Delaware and New York. While the US bankruptcy code is federal, state courts enjoy considerable judicial discretion and protect creditor interests to varying degrees. Firms sometimes file for Chapter 11 bankruptcy pre-emptively to give them leverage against creditors. If they do not file for Chapter 11 bankruptcy, creditors can file for insolvency against the firm in any state in which it has an insolvent affiliate (Bank for International Settlements, 2002).

European Union (EU). By implementing the European Insolvency Regulation (EIR) in 2000, the EU introduced what is the broadest and most effective international agreement on cross-border insolvencies. The EIR identifies the main proceedings based on the insolvent firm's centre of main interests, but also allows creditors, wherever their domicile in the EU, to initiate secondary proceedings in any member state where the firm has an establishment. This rule clearly facilitates insolvency arbitrage. For example, it allows French creditors to enforce their claims in the UK, even if the firm's centre of main interests is in a third country (Davydenko and Franks, 2006).[7]

To conclude, bondholders may benefit more substantially from those cross-border M&As which expose their firm to a jurisdiction with better creditor protection. New or increased exposure to a more creditor-friendly jurisdiction should increase pressure on management to reduce the probability of financial distress by avoiding excessive risk-taking. This pressure can only be enhanced if opportunities exist for insolvency arbitrage, because a diligent or astute creditor should always have the incentive to exploit disparate priority rules and other differences in creditor protection.

c) Accounting standards

The quality of the accounting standards is also an important factor determining shareholder protection. The accounting standards applying to the newly merged firm are by default those of the country of the acquiring firm. Firms can exceptionally alter that situation via contractual arrangements. Indeed, merging entities sometimes opt for the accounting standards of a third country or region, the most common choices being US GAAP and IFRS.

d) Law enforcement

The lack of law enforcement and the level of corruption in a country have a significant influence on (foreign) investments as they distort the economic and financial environment and reduce the efficiency of government and business by enabling people to assume positions of power through patronage rather than ability. La Porta et al. (1998) define corruption as the bribes connected with import and export licences, exchange controls, tax assessment, policy protection, and loans. Clearly, a firm with international operations is influenced by the corrupt practices in the countries where it operates, pays taxes, and where its creditors are located (Bris and Cabolis, 2008). Corruption is inherent to the country where the firm's real activities take place and not necessary the country where the firm is either domiciled or incorporated. It follows that cross-border M&As are subject to the levels of corruption prevailing in the countries of

[7] In France, insolvency proceedings are administered by the courts that strive to maintain the firm as a going concern. Even secured creditors have little confidence in recovering their debts, because their claims are subordinated to government and employee claims, and they can neither seize the collateral nor control the timing and method of collateral realization. In contrast, creditors in the UK have extensive powers in seizing the collateral and have strong incentives to race against management and each other. In fact, a creditor with a floating charge can sell the entire firm and its assets without taking into account the interests of other claimants. Finally, even creditors with unsecured claims have some liquidation rights.

both the bidder and the target. When making a takeover decision, the acquiring firm may have to familiarize itself with the system of political relations and the local administration prevailing in the country where the target firm operates. Similarly, target firms may become subject to the corrupt system of the acquirer's country after the takeover. Evidence in the literature suggests that the level of law enforcement in the host country affects foreign investors.

2.2 Empirical evidence

This section reviews the empirical literature on the impact of differences in corporate governance regulation on bidder and target performance and value in cross-border takeovers. Rossi and Volpin (2004) investigate whether cross-border mergers and acquisitions are a means enabling a company to opt into another governance system. They base themselves on La Porta et al. (1997, 1999, 2000, 2002) who have shown that differences in investor protection affect the firm's ability to raise external funds through differences in the rate of return required by investors. In particular, Rossi and Volpin (2004) hypothesize that the cost of capital decreases when a target is acquired by a bidder with better investor protection. Hence, it makes sense for targets with poor investor protection to be taken over by bidders with higher better protection. Rossi and Volpin (2004) find that, compared to the bidders, targets tend to be located in countries where shareholder protection is less tightly regulated and enforced. Consequently, cross-border M&As enhance convergence towards stronger investor protection. In addition, better shareholder protection induced by cross-border mergers translates into a higher value for the whole industry to which the target belongs. Rossi and Volpin (2004) conclude that stronger shareholder protection in the bidder's country has a positive impact on takeover volume, on bid premiums, on the number of hostile cross-border takeovers and on the number of takeovers of poorly-governed targets by well-governed bidders. In addition, better bidder protection enables bidders to make more frequently all-equity offers.

Bris et al. (2008) adopt an industry perspective in their analysis of the impact of changes in national corporate governance systems through takeovers. They predict that a cross-border acquisition of a target with poor corporate governance by a better-governed bidder has a positive impact on the value of the whole industry (as measured by Tobin's q).[8] They confirm that most acquisitions are made by companies from countries with better creditor protection, higher accounting standards, and less corruption. Bris and Cabolis find that the Tobin's q of the target's industry is positively related to an improvement in shareholder protection, a decrease in creditor protection, better accounting standards, and lower levels of corruption. In addition, the authors find weak evidence that the Tobin's q of the acquirer's industry increases when the target is from a country with stronger investor protection. They argue that, even though acquirers are not required to adopt the corporate governance practices of the target, this result suggests that in practice acquirers do so. To conclude, Bris and Cabolis (2008) show that there is significant evidence of contractual convergence of corporate governance via cross-border M&As.

[8] The quality of the corporate governance system is measured in terms of its shareholder protection, creditor protection, accounting standards, and the level of law enforcement.

In contrast to Bris and Cabolis (2008), Kuipers et al. (2003) focus on the firm level. They test their agency cost contracting hypothesis which states that companies from countries with strong investor protection act in the interest of their shareholders and hence only undertake profitable acquisitions. In contrast, their contractual convergence hypothesis predicts that companies from countries with weak investor protection acquire firms with better protection (these are US companies in the Kuipers et al. study) with the aim of bonding themselves to the better investor protection. Kuipers et al. (2003) conclude that the level of shareholder protection in the bidder's country is positively related to the target's expected performance (the cumulative abnormal returns (CARs)). The authors conclude that their findings are mostly in line with the agency cost contracting hypothesis.

Starks and Wei (2005) also assume that the direction of the corporate governance spillover is from the bidder to the target. However, they expect that the premium paid to the target shareholders decreases with the quality of the corporate governance system of the bidder's country: if the target is acquired by a bidder from a country with weaker corporate governance, the target shareholders will demand a higher premium in order to compensate them for the increased risk exposure. The authors focus on all-equity cross-border acquisitions as they make the bidder's risk profile relevant to the target shareholders. Starks and Wei explain the fact that US targets earn significant abnormal returns at the announcement of takeovers by bidders from countries with weak corporate governance by the need for the target shareholders to be compensated for the decrease in investor protection.

Consistent with Bris et al. (2008) and Rossi and Volpin (2004), Martynova and Renneboog (2008a) find that bidders more frequently score higher than the targets on various corporate governance indices. Whereas they find support for the positive spillover effect, they do not find support for the negative spillover hypothesis. As mentioned above, the alternative hypothesis to the negative spillover hypothesis, the bootstrapping or bonding hypothesis (Doidge et al., 2008) states that acquirers with weak corporate governance use the acquisition as a device to bond themselves to the stricter investor protection of the target. The bidder's shareholders will then benefit from the increased investor protection via the positive valuation effect. When the bidder comes from a country with weaker corporate governance standards, Martynova and Renneboog (2008b) show that both the bidder and the target returns are higher lower. While this result is in contradiction with the negative spillover hypothesis, it may still be compatible with the bootstrapping hypothesis: it seems that bidders bootstrap to the better governance regime of the target and experience a share price increase. Importantly, the bootstrapping effect is mainly observed for partial acquisitions. This makes sense as these acquisitions which still involve some of the target shareholders (i.e. those who did not sell out) after the deal and the target firm remaining listed on its home country's stock exchange. In other words, these are the deals where the target remains as a separate entity with strict governance standards which the bidder is obliged to follow.

Bris and Cabolis (2007) study the acquisition of France's Rhône-Poulenc by Germany's Hoechst. In 1999, Hoechst acquired Rhône-Poulenc for EUR 17bn in an all-equity bid. The merger, which resulted in the creation of Aventis, is particularly interesting because the two firms are from countries with different legal origins and hence different corporate governance systems. Furthermore, both firms were cross-listed in the US. While the corporate governance structures of the French and the German firm were very different, the merged firm adopted governance structures (e.g. the board structure and voting procedures) from both Hoechst and Rhône-Poulenc. The shareholders of Aventis ended up being better protected against managerial expropriation than they were under the French system.

Whereas investor protection can be transferred across countries, La Porta et al. (2000) argue that this is not the case for creditor protection as the target firm's assets remain under the jurisdiction of the country of the firm's physical location. Accordingly, Bris et al. (2008) do not find a significant relationship between improvements in creditor protection and industry value (measured by the industry's Tobin's q). In contrast, Renneboog and Szilagyi (2006) find creditor protection spillover effects when they investigate the impact of changes in creditor protection on bondholder returns. They examine deals involving European bidders with Eurobonds outstanding and show that the legal protection of creditors is a strong predictor of bond performance. This result suggests that cross-border deals provide much greater scope for the functional spillover of creditor protection than is assumed by La Porta et al. (2000). This spillover effect is intensified by the ability of creditors to arbitrage across legal systems, and ultimately reduce what are the agency costs of debt.

Finally, according to Bris et al. (2008), adopting stricter accounting standards through cross-border takeovers is associated with a significant increase in industry value (industry Tobin's q). The value of the bidder's industry also increases if the target country is relatively less corrupt. However, the Tobin's q of the target industry is not affected by the degree of corruption in the bidder's country.

[INSERT TABLE 1 ABOUT HERE]

The empirical evidence on the impact of differences in corporate governance quality on the returns earned in cross-border acquisitions are summarised in Table 1. There is broad consensus in the literature that: (i) companies from countries with weak corporate governance standards are considered attractive takeover targets; (ii) targets with better shareholder protection require a higher takeover premium which reflects the increased risk resulting from a reduction in shareholder protection and (iii) targets benefit from an acquisition by a bidder with better corporate governance, while bidders lose value when they acquire a company with weaker corporate governance.

3. (Re)incorporations

There are two principles on what law applies to incorporations. According to the 'real seat principle', the relevant law is the law of the location of the company's headquarters or main activities. Conversely, the 'incorporation principle' implies that the relevant law is the law of the country of incorporation. More specifically, under the former principle, firms must apply the corporate law of their real seat's geographical location, whereas the latter principle allows firms to choose freely the legislation that they wish to comply with. Companies from countries applying the real seat principle cannot reincoporate in another country as the main place of real activity and corporate law must coincide (Becht, Mayer, and Wagner, 2008). Most Continental European countries follow the real seat principle, while the incorporation principle has been adopted by the UK, Ireland, and the US. Until recently, only US corporations have been able to choose or change their state of incorporation, as in Europe many barriers were in place restricting corporate mobility. However, after a radical change in EU law following a series of recent rulings by the European Court of Justice (ECJ), cross-border mobility via incorporations, but not via reincorporations, is now possible within the EU (Becht et al., 2006).

A variety of motives have been advanced and explored in order to explain why companies may want to reincorporate (Cumming and MaIntosh, 2002). They are: (1) the setting up of takeover defences, (2) the reduction in directors' liability, (3) the move to a jurisdiction with more flexible corporate laws, (4) savings on tax or franchise fees, (5) the reconciliation of the legal and operating domicile of the firm, (6) and the facilitation of cross-border mergers and acquisitions. Among these six motives, the adoption of takeover defences and the limitation of directors' liability have proved to be the most popular ones driving reincorporation proposals (Heron and Lewellen, 1998).

The economic analysis of freedom of (re)incorporation raises two closely related issues: the impact of inter-jurisdictional competition for corporate charters on corporate law and the effect of jurisdiction shopping for corporate charters on firm value (Becht et al., 2008). When corporations are free to choose their regulatory regime, they will opt for jurisdictions that deliver the most desirable legal services at the lowest costs. Consequently, competition between jurisdictions may occur to attract and retain incorporations. This inter-jurisdictional competition for corporate charters is expected to play a significant role in shaping corporate law and governance across countries, and in turn the value of a firm. According to one school of thought, the intensified competition between legal regimes leads to the design of high quality corporate law that promotes economic efficiency (see e.g. Winter, 1977; Romano, 1985). Corporations will end up establishing their legal seat in a jurisdiction where the *legal services are provided at the lowest cost and priced most properly in relation to their needs* (Fluck and Mayer, 2005). This is often called the *cost-avoidance hypothesis*. Legal competition may thus lead to a '*race to the top*'. The alternative view is more sceptical with respect to the incentives provided by jurisdictional competition. In particular, regulators may respond by endorsing *laws that cater for managerial rather than investor interests* in order to increase the potential revenues from incorporation (the *shareholder-exploitation hypothesis*). The resulting '*race to the bottom*' in terms of standards of legal protection is likely to harm economic efficiency (Cary, 1974).

Both in the EU and the US, corporate governance laws are enacted at the state level.[9] Accordingly, there is significant variation across states in terms of the choices offered to individual companies and in terms of the obligations and duties imposed on them. For instance, some jurisdictions protect firms against the threat of a takeover whereas others limit the use of takeover defences. The differences are especially noticeable within the EU given the wide cultural and institutional variations across its member states.

3.1 Inter-jurisdictional competition in the US

Each of the fifty US states maintains its own court system and enacts its own set of corporate rules and procedures for resolving disputes that may arise within corporations. The law of the state of incorporation governs the internal affairs of a firm, e.g. with respect to whether shareholders are entitled to vote on a particular matter. Generally speaking, the location of incorporation is irrelevant to how firms' operations are going to be taxed or regulated (Greenwood, 2005). Hence, according to the conventional view, the incorporation choice is a pure choice of legal regime (Bebchuk and Cohen, 2003). If the decision to incorporate in a particular jurisdiction can be characterized as a 'purchase of a legal regime', then each state can be characterized as competing for incorporations (Ferris et al., 2004).[10] However, recent evidence indicates that in the United States, only Delaware actively competes for incorporations: firms decide either to stay where they "grew up" or reincorporate to Delaware. They do not choose between Delaware and a third state.

The theory on the race to the top in the market for corporate law assumes that the board of directors selects the particular law and governance regulation that maximizes firm value (Winter, 1977; Daines, 2001). Bar-Gill, Barzuza, and Bebchuk (2006) do not agree with this race to the top argument. They argue that the market for corporate law is only capable of performing well with respect to rules that are not related to private benefits of control. When dealing with rules that affect private benefits or when a conflict of interest arises, competition drives states to offer legal rules favourable to managers but not to shareholders. Self-interested managers tend to opt for lax corporate laws that increase their private benefits at the shareholders' expense. Consequently, states may openly compete for incorporation

[9] An interesting aspect of corporate law in the US is the competitive federalism. US corporate law is regulated and enforced via two parallel systems. The federal government and the state authorities are both involved in the corporate lawmaking. This makes the competition between the states more complicated, as the states do not only compete amongst each other, but they also subject to federal interventions (Roe, 2003b, 2005b). In particular, Becht, Jenkinson, and Mayer (2005) state that corporate lawmaking in the US does not just reflect horizontal competition between states but also a three-way interplay between states mindful of each other and the federal government. The federal government intervenes whenever it believes that the state legislation falls short in certain areas: regulatory responses to corporate governance failures tend to be initiated at the federal level. Examples of federal government intervention through legislation include the Securities Act of 1933, the Williams Act of 1968 (takeovers), and the Sarbanes-Oxley Act in 2002.

[10] Only Delaware has been successful in attracting (re)incorporations (Kahan and Kamer, 2001). Daines (2001) states that US firms essentially face a single choice and not fifty alternatives: they incorporate either in their home jurisdiction or in Delaware. The market for corporate charters is thus characterized by a bimodal pattern: 95% of all firms that seek legal rules outside the state of their headquarters end up in Delaware. Therefore, Daines argues that the concept of a nationwide market in legal rules may be misleading. Delaware's success in the corporate charter market is explained by two institutional factors, namely high franchise fees and a specialized court. Its special court, the Court of Chancery, deals exclusively with corporate legal cases. Delaware's Court of Chancery, its unique administrative and legal expertise in corporate law and its efficiency in providing legal services to companies have encouraged companies to opt for its legislation.

business by serving managerial preferences with respect to an important set of corporate issues, leading to a race to the bottom (see e.g. Cary, 1974; Bebchuk, 1992; Bebchuk and Ferrell, 1999 and 2002). Ferris, Lawless and Noronha (2004) find that US firms are sensitive to the differences in corporate laws across states. They observe that managers make the decisions as to the location of their firm's headquarters and the location of its incorporation based on the degree of discretion they will be given in each location.

In turn, Cary's (1974) argument about the race to the bottom has been criticised and challenged by other scholars (see e.g. Winter, 1977; Easterbrook and Fischel, 1991, Romano, 1985, 1993, 1998) who claim that jurisdiction shopping is an indispensable part of the competition dynamics and not necessarily unfavourable to shareholders. Dodd and Leftwich (1980), Romano (1985), Peterson (1988), Netter and Poulsen (1989) show that firms incorporated in Delaware have higher share prices on average and generate positive abnormal returns.[11] Most of this literature hence supports the cost-avoidance hypothesis of (re)incorporations and refutes the shareholder-exploitation thesis (see Table 2). Daines (2001) provides further support for the cost-avoidance hypothesis as he finds that that a Delaware incorporation leads to a higher Tobin's Q after controlling for size, industry, growth opportunities and financial performance. He also reports that the higher probability of being taken over that comes with an incorporation in Delaware suggests that Delaware's law facilitates takeovers and thus enhances shareholder value. The validity of the race to the top argument is questioned by Bebchuk, Cohen, and Ferrell (2002), Bebchuk and Cohen (2003) and Subramanian (2004) who contend that the findings on higher shareholder values for Delaware firms do no longer hold after 1996 (see Table 3).

[INSERT TABLES 2 AND 3 ABOUT HERE]

Bebchuk and Cohen (2003) argue that allowing firms to adopt anti-takeover statutes helps states to retain their own firms and to attract incorporations from out-of-state firms. Heron and Lewellen (1998) show that firms often reincorporate in order to set up takeover defences (e.g. poison pills), even to the detriment of their existing shareholders. This view is supported by the overwhelming majority of event studies on the effects of anti-takeover devices which find that the adoption of such devices destroys shareholder wealth (see e.g. Bhagat and Brickley, 1984; Malatesta and Walking, 1988; Agrawal and Mandelker, 1990). For this reason, the UK City Code on Takeovers discourages any type of defensive tactics and instead promotes takeover bids (Bebchuk and Cohen, 2003; Fluck and Mayer, 2006). For example, the Code does not permit firms to introduce poison pills once they have become subject to a takeover bid.

Advocates of state competition in the US argue that anti-takeover statutes are perverse because they do not serve shareholders' interests (see e.g. Easterbrook and Fischel, 1991; Romano, 1993). Consistent with this view, Karpoff and Malatesta (1989 and 1995) and Szewczyk and Tsetsekos (1992) find that

[11] Conversely, Heron and Lewellen (1998) find insignificant abnormal returns.

firms incorporated in states with strong anti-takeover legislation suffer statistically significant stock price declines. Furthermore, Bertrand and Mullainathan (1998 and 1999) find evidence indicating that the adoption of anti-takeover statutes increases agency costs. They observe increased extraction of rents through executive compensation and reduced managerial incentives. Indeed, the adoption of anti-takeover statutes is seen as an adverse outcome of state competition, whereby excessive protection is provided to increase managerial private benefits rather than shareholder wealth (Bebchuk, 1992; Bebchuk and Ferrell, 1999; Bar-Gill, Barzuza, and Bebchuk, 2006).

Based on the argument that state anti-takeover statutes harm shareholders, state competition may discourage such practices. However, this prediction is not supported by the empirical evidence: Bebchuk and Cohen (2003) show that states with no anti-takeover statutes are not very good at attracting and retaining incorporations, while states that allow strong anti-takeover statutes are the most successful in the (re)incorporation market. In contrast, Romano (2001) does not believe that increased anti-takeover protection is an important reason to reincorporate: Delaware has adopted fewer and milder anti-takeover statutes than Pennsylvania, Ohio, and Massachusetts but still remains the most successful state in luring incorporations. Moreover, Delaware has developed an extensive body of case law on takeovers, which questions the legal standing of the adoption of some anti-takeover statutes. Table 4 summarizes the results from Subramaniam (2001) and Bebchuk and Cohen (2003) who disagree with Romano. The former find that, when there are strong anti-takeover defences in the headquarters state, there is less reason to (re)incorporate in Delaware or another state. In general, anti-takeover protections improve a state's competitive position in the corporate charter market by enhancing both its ability to retain local firms and attract incorporations from other states. These findings provide further support for the race to the bottom hypothesis as competition provides states with strong incentives to adopt anti-takeover statutes that do not serve shareholders.

[INSERT TABLE 4 ABOUT HERE]

3.2. American federalism

Roe (2003b, 2005b) has recently challenged the idea that the "race" whether to the top or the bottom, is so central to mechanics of making American corporate law it has been thought to be. If the issues are truly central to the American economy -strong enough to seriously affect capital costs or sufficiently scandalous to attract media attention- then the issue frequently moves to the federal agenda, for Congress, the SEC, or the federal courts to handle. He argues (or observes) that the United States has two parallel makers of corporate law, one at the state-level (primarily in Delaware) and another in Washington. Securities rules deeply affect corporate governance and the allocation of authority between managers and shareholders. When a deep problem arises (such as the Enron and WorldCom scandals), there's a reaction in Washington, not a race among states. Sarbanes-Oxley is the latest reaction, but not the first: the securities laws are examples, as are their frequent and substantial amendments; the proxy rules of the 1950s (managed by the SEC) are another example; the Williams Act on takeovers and federal takeover judicial actions are another; the expansion of fiduciary duties via the broad anti-fraud interpretations in the 1960s and early 1970s (and their subsequent contraction) are yet another. Moreover, Delaware players are exquisitely aware that if they act badly, the issue will move to Washington, pushed their by federal regulators, offended interest groups, or American public opinion.

3.3 Increasing cross-border incorporation mobility in the EU

The EU law on incorporations has its origin in Article 48 of the Treaty of Rome: companies incorporated in one member state of the EU have the right to operate in any other member state. Although the principle of freedom of incorporation was laid down in the founding treaties of the EU, it was only applied in the UK and Ireland as all other EU member states had adopted the real seat doctrine. Basically, firms in the latter countries were required to be incorporated where they operated. In recent years, radical changes in EU company law have taken place via a series of rulings by the ECJ. The *Centros* (1999), *Überseering* (2002) and *Inspired Art* (2003) rulings[12] have reaffirmed the principle of freedom of establishment within the EU and opened up the EU to cross-border incorporation mobility. According to Becht, Mayer, and Wagner (2008), these rulings constitute one of the strongest attempts to deregulate company law in Europe and provide a natural experiment on the impact of regulation on corporate mobility. Some legal scholars expect a migration of companies from other EU countries to the UK and the export of UK corporate laws to other countries. The UK is the preferred country of incorporation because it has the simplest incorporation procedures, the most liberal corporate laws, and the lowest incorporation costs in the EU. Becht et al. (2008) analyse the effects of deregulation on corporate mobility within Europe by using data on 2.14 million newly incorporated UK firms: they show that the ECJ rulings have had a striking impact on the legal geography of new company formations. In particular, they observe a significant increase in the number of companies from all EU member states incorporating in the UK during the period 2002-2005: the number of new private limited companies from all other EU member states established in the UK was over 55,000.[13]

4. Cross-listings

A cross-listing consists of a firm listing on a foreign stock exchange at the time of its initial public offering (IPO) on its domestic market or thereafter.[14] Cross listing on a market with better corporate governance regulation is one way for a firm to improve its own corporate governance. According to Coffee (2002), firms from weak legal regimes cross list on the US market, a market with superior

[12] See ECJ, Case C-212/97 Centros Ltd and Erhvervs-og Selbskabsstyrelsen (1999) ECR I-1459; Case C-208/00 Überseering BV and Nordic Construction Company Baumanagement (NCC) (2002) ECR I-9919; Case C-167/01 Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd (2003) ECR I-10155.

[13] Corporate mobility in the EU only applies to private limited companies, which are mostly small firms managed by only one or two owner-directors. The shareholder-manager conflict at the basis of the US reincorporation debate hence does not apply to the EU. Moreover, in contrast to the US law on corporate mobility, reincorporation or change in legal status of existing firms is still not permitted by EU law.

[14] Conversely, a foreign listing consists of a firm, which is not yet listed on its home market, listing on a foreign market.

corporate governance regulation, in order to commit themselves not to expropriate their shareholders. This is the so called *bonding hypothesis*. In particular, Coffee (1999) argues that a US cross-listing makes it harder and more expensive for the controlling shareholders and managers to extract private benefits and to expropriate the minority shareholders. Formal disclosure rules and securities laws ensure that investors and analysts receive sufficient information, which in turn allows capital market forces to discipline controlling insiders in case of expropriation (Leuz, 2006). According to the bonding hypothesis, cross-listing creates value for firms as shares of cross-listed firms are traded at a premium relative to other firms (King and Segal, 2003; Doidge, Karolyi and Stulz, 2004; Smith, 2005).

Virtually all of the finance literature on cross-listings is concerned with the listing of a foreign company on a US stock exchange (and to a much lesser extend on the LSE). A foreign company can choose to cross-list its shares on a US exchange in two ways. It can either list its shares directly or indirectly via American Depositary Receipts (ADRs). An ADR is an instrument issued by an American commercial bank acting as a depositor. The ADR represents a fraction or a multiple of one or more shares of the foreign stock (Ayyagari, 2004). The advantages of ADRs for US investors include lower transaction costs,[15] prices and dividends being settled in USD, and the US depositary bank providing statements to the investors. In 1990, 352 companies from 24 different countries were cross-listed in the US. In 1999, this number had grown to 1,800 companies from 78 different countries (Coffee, 2002). To date, about 20% of the common stock listed on the NYSE are (cross)-listings of foreign companies (Li, 2007).

There are four different types of ADRs. A Rule 144a private offering consists of a listing on PORTAL, a privately owned electronic market where only qualified institutional buyers (QIBs) can trade. This market is not regulated by the Securities Exchange Commission (SEC). A Level I ADR is the listing with the least stringent requirements, resulting in a firm's ADRs trading on the US over-the-counter market (OTC). The firm does not need to comply with US GAAP or full SEC disclosure requirements. Conversely, a Level II ADR requires the issuing company to comply with US accounting and disclosure standards. However, only existing shares can be listed and no new capital can be raised. Finally, a Level III ADR combines a listing with the issue of new capital on the US market. Apart from the firm having to comply with the disclosure standards as per the Level II requirements, it also has to publish a prospectus and meet additional disclosure requirements.

In summary, a company choosing to cross-list via a Rule 144a private offering or a Level I ADR does not subject itself to major changes in terms of its corporate governance. The company is not required to comply with any of the accounting and disclosure requirements of the SEC. In contrast, Levels II and III ADRs similar to a full listing on a US stock exchange. As a result, the company has to follow the US listing requirements and US corporate governance regulation. Hence, Levels II and III tend to cause a major change in the company's corporate governance.

[15] Based on an estimation made by the Bank of New York, an ADR investment can save an investor 10-40 basis points annually when compared to the costs of trading and holding ordinary shares outside the US (Smith, 2005).

However, there are still some non-trivial differences between a cross-listing in the US and a US domestic listing (Ayyagari, 2004). For example, many countries recognize the depositary bank as the shareholder of the securities underlying the ADR programme, but not the ADR holders themselves. Foreign issuers are also not subject to the proxy rules of the SEC. Another important difference is that some depository agreements limit the voting rights of the ADR holders by restricting them to vote only on some predetermined issues. This limits the ability of the holders to defend themselves against possible expropriation by corporate insiders. In some cases, foreign issuers are even allowed to have internal rather than external auditors.

A number of foreign issuers have bypassed the ADR system altogether through a direct cross-listing in the US. By issuing so-called global registered shares (GRS),[16] firms can have their shares traded on both the US market and their home market. Smith (2005) explains that the growth in the number of GRS issued and traded is driven by improvements in international clearing and settlement systems, which have reduced the need of US depository banks as intermediaries. Further, the close relationship between the US and Canadian securities clearing and settlement systems explains why Canadian companies have historically directly listed their shares on the US exchanges. According to Smith, the US system is also linked with both the German and Swiss clearing systems and the links between the US and other clearing systems are being developed.

Table 5 provides a summary of empirical studies which have attempted to test the validity of the bonding hypothesis. For example, Reese and Weisbach (2002) focus on the relationship between minority shareholder protection and cross-listings by foreign firms in the US. They argue that it is often difficult for companies to raise capital in countries with weak investor protection. These companies may therefore choose to cross-list their shares on a stock exchange with better investor protection. By doing so, they signal to the market that their investors are better protected against expropriation and increase the willingness of investors to provide funds which then lowers the cost of capital. If reducing the cost of capital is the main motive for a cross-listing in the US, one would expect equity offerings following the cross-listing. Reese and Weisbach (2002) report that listed companies from French civil law countries (which are believed to have lower investor protection) have relatively more cross-listings in the US (10.52%) than companies from English common law countries (6.66%). This pattern supports the bonding hypothesis. Reese and Weisbach also find that while French legal origin firms opt for the more stringent governance rules of the US (which ensure better investor protection), English legal origin firms are more concerned with expanding their shareholder base and increase their visibility and the liquidity of their shares. They proceed by investigating the relationship between the company's home country legal origin and the number of equity offerings following the cross-listing. They find evidence supporting the bonding hypothesis as firms from civil law countries are more likely to issue equity outside the US whereas firms from common law countries are more likely to issue their equity in the US.

[16] These are shares which allow foreign companies to be directly listed on a US stock exchange. DaimlerChrysler was the first company to issue such shares (Harris et al., 2004)

[INSERT TABLE 5 ABOUT HERE]

Doidge (2004) examines whether cross-listed companies have lower voting premiums (as measured by the ratio of the price of the voting right to the cash flow right). Consistent with the bonding hypothesis, he finds that firms cross-listed on a US stock exchange through Level II or Level III ADRs have significantly lower voting premiums than firms without a cross-listing. However, firms that cross-list via Level I ADRs or Rule 144a ADRs do not have lower voting premiums. There is a negative relationship between the average change in the voting premium and the investor protection of a firm's home country.

Doidge, Karolyi, and Stulz (2004) examine the valuation effect resulting from a cross-listing in the US. They expect the cross-listing in the US to result in a reduction in the firm's cost of capital for at least four reasons. First, the cross-listing increases the shareholder base. Therefore, a firm's riskiness is shared more widely, which may lower the risk premium required by investors. Second, the cross-listing in the US increases the liquidity of the firm's stock, which lowers the risk investors face when buying the stock and reduces their required rate of return. Third, the higher disclosure standards reduce the information asymmetry between insiders and outsiders. This reduction may lower the chance of expropriation and thus the risk of investing, which results in a lower cost of capital. Finally, a US cross-listing leads to increased scrutiny and monitoring by the financial press, which again cuts down the informational asymmetry and reduces the cost of capital. Doidge et al. argue that firms with large shareholders face a trade-off when cross-listing. On one hand, the reduction in the cost of capital increases the ability to finance the growth opportunities more easily. This results in increased future cash flows and a higher share value for the (controlling) shareholders. On the other hand, the increase in investor protection reduces the potential private benefits of control obtained by the large shareholders. Hence, from the perspective of the controlling shareholder, a cross-listing only makes sense if the increase in share value outweighs the loss in private benefits of control. Therefore only companies that face high growth opportunities will choose to cross-list in the US. Doidge et al. test this valuation effect using Tobin's q. They find that the Tobin's q for cross-listed firms is higher (by 16.5%) that for other companies from the same country. For companies from countries with low investor protection, there is a stronger positive relationship between the growth opportunities and the valuation effect of the company due to the cross-listing. All in all, this paper supports the bonding hypothesis: companies with a strong need to attract external capital commit themselves to better corporate governance by cross-listing on a US stock exchange.

Rather than focusing on US cross-listings and the cross-listing premium, Abdallah and Goergen (2008) examine the choice of host market for a sample of 175 companies cross-listing on 19 different stock exchanges. There are at least three reasons why the firm's ownership and control may influence the decision as to the location of the market for the cross-listing. First, a large shareholder faces a trade-off between the benefits from dispersed ownership which are risk diversification and liquidity and those from retaining control. A large shareholder will only be willing to give up control if the benefits from doing so outweigh her private benefits of control. If this is the case, the large shareholder may decide to cross-list her firm on a market with a higher valuation brought about by better investor protection. Second, owners of high-risk firms will prefer to cross-list on a market with higher diversification potential, which may be related to the degree of shareholder protection. Hence, owners of high-risk firms may decide to cross-list on a stock market with better investor rights. Finally, while the link between the choice of the host market and a firm's control structure is not straightforward, Abdallah and Goergen expect there to be a link between the two. They also argue that some of the factors explaining the decision to cross-list – such as financing needs and financial constraints, share liquidity, and the bonding hypothesis – may also explain the choice of the cross-listing location.

Their dependent variable is the improvement in investor protection brought about by the cross-listing. As hypothesized, they find that a firm's control structure does indeed determine the cross-listing location as companies with concentrated control are more likely to cross-list on markets with better investor protection. However, contrary to their expectations, the authors find that firms with substantial private benefits of control cross-list on markets with better investor protection. This relation is particularly pronounced for firms where control is concentrated in the hands of a single shareholder. In addition, firms with minority shareholders that are more likely to be expropriated by the controlling shareholder cross-list on better markets to bond themselves to protect the minority shareholders. Conversely, firms with several large shareholders are more likely to list on a market with low investor protection. In sum, Abdallah and Goergen find strong support for the bonding hypothesis. They also report that high-risk firms and firms with large financing needs and those suffering from illiquidity are more likely to cross-list on markets offering better shareholder protection than their home markets.

Lel and Miller (2006) argue that, after the cross-listing in the US, investors find it easier to dismiss the CEO when their firm's performance is poor. Hence, there should be increased CEO turnover subsequent to the cross-listing. They find that this is indeed the case for cross-listed firms through Levels II and III ADRs, which is in line with the bonding hypothesis,

Doidge et al. (2008) predict that opting for a better corporate governance system results in a share price increase. However, the controlling shareholder loses her private benefits as a consequence of the increased disclosure and more stringent legal requirements. If the loss in private benefits outweighs the increase in the share price, it is unlikely that the controlling shareholder will choose to cross-list the company on a US stock exchange. Doidge et al. use two different proxies for private benefits of control. The first one is the difference between the control rights and cash flow rights held by the largest blockholder (the control wedge measuring the potential loss of private benefits of control). The second one is the percentage of ultimate control rights held by the firm's officers, directors, top-level managers, and their family members. They find that the control rights held by the corporate insiders and the difference between the control-rights and cash-flow rights held by the controlling blockholder reduce the probability of a US cross-listing.

To summarise, the empirical literature provides strong support for the bonding hypothesis. Firms based in countries with weak shareholder rights choose to cross-list on markets with better investor protection to commit themselves not to expropriate their minority shareholders.

However, recent changes in US corporate governance regulation have changed investors' and academics' view on the benefits from cross-listings. For example, Romano (2005) argues that the 2002 Sarbanes-Oxley Act (SOX) is an ill-conceived piece of legislation that was adopted in a frantic political environment. SOX's aim was to restore quickly investor confidence after the Enron debacle by regulating corporate gatekeepers.[17] The law applies to all US public companies and to foreign companies cross-listed in the US via Levels II or III ADRs (Litvak, 2007a). In the years subsequent to the introduction of the SOX, a large number of firms delisted. For instance, during 2003 and 2004, approximately 300 US companies deregistered their common stock for reasons other than mergers, acquisitions, liquidations, registration withdrawals, or going-private transactions (Leuz, Triantis, and Wang, 2006). A listing on a stock exchange brings about substantial direct and indirect costs. According to Marosi and Massoud (2007), a major factor leading companies to delist or go dark during 2002-2004 were the compliance costs of SOX which have significantly increased the direct and indirect listing costs. The indirect costs are caused by the enhanced accountability of corporate executives and boards in producing and verifying publicly available information. Direct costs are generated by the increased responsibilities of the auditors under SOX and the resulting increase in audit costs and fees paid by the firms.

Leuz, Triantis and Wang (2006) confirm the relation between the introduction of SOX and the number of delistings. Foley and Lardner (2007) provide further evidence based on a survey of 147 public companies. Seventy percent of the interviewees expressed concern regarding the increase in administrative fees caused by SOX and other corporate governance reforms, and 82% complained that the reforms had been too strict. Moreover, Lew and Ramsay (2006) and Engel et al. (2007) argue that SOX has increased the attractiveness of going private (or dark), particularly for smaller companies for which compliance costs are a major concern. All these results suggest that going private is the optimal response for those firms whose SOX compliance costs exceed the increase in shareholder value arising from improved governance. Chhaochharia and Grinstein (2007) find that, while the costs of SOX hit small firms the most, the SOX rules tend to improve the value of large companies.

Smith (2005) investigates whether the number of delistings of foreign firms changed in response to SOX. Most of the firms that delist following the passage of SOX claim that the increased costs of maintaining a US listing combined with a low trading volume no longer make a dual listing attractive. The SOX compliance costs also help to explain the decline in business combinations between foreign firms and US-listed firms: foreign firms prefer to merge with firms that are not listed in the US in order to avoid

[17] These gatekeepers are the lawyers, accountants, auditors, investment bankers, securities analysts, corporate directors and officers, stock exchanges, the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, and a variety of other governmental and non-governmental bodies, organizations, and professions.

SOX-related expenses. Litvak (2007a) finds similar evidence: she reports that the stock prices of foreign firms subject to SOX (Levels II and III ADRs) decreased significantly relative to cross-listed firms not subject to SOX and to firms with a cross-listing.[18] Furthermore, Litvak (2007a, b, 2008) finds that the impact of SOX on stock prices varies considerably across the affected foreign firms. Whereas well-governed firms and firms from countries with good investor protection carry a larger part of the net burden, faster-growing companies with relatively large financing needs suffer smaller losses, especially if they are from countries with weak investor protection. The overall evidence suggests that SOX hurts the most the more profitable, smaller, and riskier firms as well as firms from countries with good shareholder protection, while helping high-growth firms from countries with weak protection.

Smith (2005) finds a concave relationship between the SOX announcement returns and the La Porta et al. (1998) measures for home-market accounting standards and shareholder protection laws. The bonding hypothesis holds true for firms from countries with mid-level accounting standards and shareholder protection laws as the value of these firms increases significantly after the announcement of the SOX enactment. However, the SOX announcement returns are significantly negative for firms from countries with high-level accounting standards. This negative effect supports the *avoidance hypothesis* which states that firms with high quality corporate governance have little to gain from adopting even more stringent standards. Finally, the returns for firms from low-level countries are positive but not significant. These results show that SOX can either be value-enhancing or value-destroying, depending on whether the net benefits from the improved disclosure and governance outweigh the compliance costs.

Finally several other papers study the consequences of a delisting for the shareholders. For example, Marosi and Massoud (2007) and Leuz, Triantis, and Wang (2006) show that shareholders suffer significantly negative cumulative abnormal returns upon the announcement of the deregistration.

In sum, the empirical literature provides strong support for the bonding hypothesis as firms from countries with weak investor protection are reported to cross-list on markets with better laws to commit themselves not to expropriate their shareholders. Finally, there is evidence suggesting that, although the Sarbanes-Oxley Act may have benefitted a minority of firms, it has also imposed significant costs, i.e. costs outweighing its benefits, on the majority of foreign firms cross-listing in the US.

5. Conclusion

The traditional view that each state or country is free to choose its law no longer applies in a world with an increased use of contractual corporate governance devices. Indeed, several contractual devices, the

[18] While a number of recent studies (see Doidge, Karolyi, and Stulz (2007); Zingales (2007); Zhang (2007); Berger, Li, and Wong (2005); Smith (2006); Li (2007)) have attempted to examine the impact of SOX on the cross-listing premium, we focus mainly on Litvak (2007b and 2008). The reason is that, unlike the other studies measuring the long-term effects of SOX, Litvak's work controls for contemporaneous events that may also affect the Tobin's q's of foreign companies. The cross-listing premiums in her papers are defined and measured as the difference between the Tobin's q of a cross-listed firm and the Tobin's q of a firm without a cross-listing from the same country matched by the propensity to cross-list.

main ones being cross-listings, (re)incorporations, and cross-border acquisitions, enable firms to re-design their corporate governance and to deviate from or even choose their national standards. The question that arises is whether firms are engaged in a race to the bottom or to the top.

However, before attempting to answer this question let us first review the three main contractual devices that enable firms to adjust their governance. First, cross-listings allow firms to choose the stock exchange(s) on which they want to be listed and hence the listing rules (the standards of disclosure, accounting rules, code of conduct, and corporate law) they are subject to. This way, firms can opt for either a more stringent corporate governance regime or a more lax one. Second, firms can also change their corporate governance regime by becoming a target in a cross-border takeover. In other words, if the acquirer is based in a more shareholder-oriented regime, the target shareholders may end up being better protected. Even when the acquirer's corporate governance regime is less shareholder-oriented and provides less investor protection, the acquirer can still bond itself or bootstrap to the more stringent regulation of the target. Third, a (re)incorporation enables firms to opt directly into another corporate governance regime.

Let us return to the question whether contractual corporate governance induces a race to the bottom or a race to the top. In other words, do firms prefer corporate governance mechanisms that erode shareholder protection and reduce corporate value (the shareholder exploitation hypothesis) or do they prefer those mechanisms that are beneficial for investors (the bonding or cost avoidance hypothesis)? With regard to *(re)incorporations* in the US, there is clearly not a race to the bottom as the states with the most detrimental corporate governance regulation for shareholders are not successful in attracting (re)incorporations. Still, there is hardly a race to the top either as the majority of incorporations and most of the reincorporations take place in Delaware. In addition, Bebchuk and Cohen (2002) and Bebchuk et al. (2003) found that over the past decade Delaware (re)incorporations have not created value. For a state to be attractive to corporate managers, it has to permit the use of anti-takeover devices. Therefore, the trend in (re)incorporations is unlikely to start a race to the top. A recent regulatory change has made it possible for EU firms to incorporate (but not reincorporate) in any EU country. However, the increasingly popular choice of incorporating in the UK seems to be mainly triggered by the lower incorporation costs.

Conversely, with regard to *cross-border acquisitions*, there is a clear race to the top for the following two reasons. First, acquirers from corporate governance regimes offering better investor protection more frequently take over targets with weak shareholder-orientation. Second, if the target is based in a better corporate governance regime, the evidence shows that acquirers with poorer shareholder protection voluntarily bootstrap or bond themselves to the more stringent level of corporate governance regulation. Similarly, the evidence on *cross-listings* is in line with the race to the top argument as those firms that have difficulty raising finance and/or have a high potential for their minority shareholders to be expropriated by the large shareholder choose to cross-list on markets with better investor protection.

Unfortunately, the Sarbanes-Oxley Act seems to have resulted in constraining certain types of firms to opt into a better corporate governance regime.

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Table 1: Empirical research on cross-border M&As

This table provides the recent research on the impact of corporate governance in cross-border M&As on premiums, returns, value, and takeover activity. As a proxy for the corporate governance quality the papers use the index of La Porta et al. (1998), except for the paper by Martinova and Renneboog (2007), which uses the corporate governance index score of Martinova and Renneboog (2006). CAR stands for cumulative abnormal return and BHAR for Buy and hold average return. CG stands for corporate governance. The column of corporate governance quality shows the relation between the dependent variable and the corporate governance quality of the target country: + indicates a significant positive result, - a significant negative one, n.s.s. is not statically significant and NA stands for non-available.

Panel A: The target's corporate governance quality							
Study	**Sample period**	**Selection criteria**	**Nr takeovers (Nr cross-border)**	**Nr of countries**	**Dependent variable**	**Corporate governance quality**	**Main results**
Bris and Cabolis (2008a)	1985-2000	Full acquisitions	20,573 (20,573)	49	Tobin's q (target's industry)	–	The weaker the target's CG standards, the higher the Tobin's q of the target's industry after a cross-border acquisition
Rossi and Volpin (2004)	1990-2002	Acquisitions of majority control	45,686 (11,638)	49	Nr of cross-border deals (as % of all deals)	–	The cross-border ratio decreases in the target's CG standards. Targets with weak CG standards are considered attractive takeover targets
					Log (takeover premium)	+	Targets with higher CG standards, earn higher premiums when acquired in a cross-border deal
Martynova and Renneboog (2008a)	1993-2001	European full and partial cross-border takeovers	2,419 (737)	29	CAR (target)	+	The target's shareholder protection is positively related with the target's CARs. Targets from countries with better shareholder protection require a higher takeover premium
					CAR (acquirer)	n.s.s.	No significant relationship between target's CG quality and the acquirer CAR.
Bris et al, (2008b)	1990-2001	Full acquisitions	(7,233)	41	Tobin's q (target's industry)	n.s.s.	This result is insignificant

Panel B. The bidder’s corporate governance quality							
Study	**Sample period**	**Selection criteria**	**Nr acquisitions (Nr. of cross-border)**	**Nr of countries**	**Dependent variable**	**Corporate governance quality**	**Main results**
Bris and Cabolis (2008a)	1985-2000	Full acquisitions	20,573 (20,573)	49	Tobin's q (acquirer’s industry)	–	The higher the bidder CG standards, the larger the negative effect on the Tobin’s q of the acquirer’s industry
Kuipers et al. (2003)	1982-1991	US successful tender offers	181 (181)	16	CAR (target)	n.s.s.	No significant relationship between target CAR and the shareholder protection of acquiring company
					CAR (acquirer)	+	Significant positive relationship between CAR of acquirer and the quality of the corporate governance system of the acquirer country.
Starks and Wei (2005)	1980-1998	Cross-border acquisitions of US targets	153 (153)	NA	Takeover premium	–	The takeover premium decreases in the quality of the bidder CG system. Targets acquired by bidders with weak CG systems require a higher risk premium.
			162 (162)	NA	CAR (target)	–	Negative significant negative relation between the bidder CG system and the target CAR. Targets demand a high premium for the loss in CG quality.
			2,419 (737)	29	CAR (acquirer)	n.s.s.	No significant relationship between the bidder CG quality and the bidder CAR after the acquisition of a US target
Sudarsanam and Qian (2007)	1998-2002	European cross-border takeovers	65 (65)	NA	BAHR (acquirer)	+	Positive significant relation between change in internal CG and BAHR. The improvement of CG through contractual convergence yields positive increase in post-merger performance
Martynova and Renneboog (2008a)	1993-2001	European cross-border takeovers	2,419 (737)	29	CAR (target)	n.s.s.	No significant relation between bidders CG quality and target CAR.
					CAR (acquirer)	n.s.s.	No significant relation between bidder’s CG quality and acquirer CAR.
Bris et al. (2008b)	1990-2001	Full acquisitions	(7,233)	41	Tobin's q (target industry)	+	Bidder’s CG is positively related to Tobin’s Q of the industry of the target.

Panel C. The difference in corporate governance quality between bidder and target

Study	Sample period	Selection criteria	Nr acquisitions (Nr. of cross-border)	Nr of countries	Dependent variable	Corporate governance quality	Main results
Bris and Cabolis (2008a)	1985-2000	Full acquisitions	20,573 (20,573)	49	Tobin's q (target 's industry)	(+)	If a target is acquired by a bidder with better CG standards, the target's value increases
					Tobin's q (acquirer's industry)	(+)	The acquired company loses in value, when acquiring a target with lower CG standards
Rossi and Volpin (2004)	1990-2002	Acquisitions of majority control	45,686 (11,638)	49	Nr of cross-border deals	(+)	The higher the difference between the quality of the CG systems of two countries, the higher the number of cross-border deals with the targets coming from the weakest CG system
Martynova and Renneboog (2008a)	1993-2001	European partial and full cross-border takeovers	2,419 (737)	29	CAR (target)	(+)	Significant positive relation between the difference in CG and the target CARs. Targets with weak CG standards benefit from an acquisition by a better governed bidder.
					CAR (acquirer)	(–)	Negative relation between the difference in CG quality and the bidder CARs. A bidder's shareholder wealth increases when it acquires a target with lower CG quality
Bris et al. (2008b)	1990-2001	Full acquisitions	(7,233)	41	Tobin's q (target 's industry)	(+)	The larger the difference in CG quality, the higher the valuation effect for the target's industry. This relationship is two–sided e.g. a positive difference yields a positive valuation effect and a negative difference gives a negative valuation effect

Table 2: US reincorporations and shareholder wealth

This table provides an overview of the studies focusing on the shareholder wealth effect of US reincorporations. The table shows the sample period, the selection criteria, size of the event window, the subsamples, sample size, and the cumulative abnormal returns (CAARs) measured before the reincorporation (ex ante), after the reincorporation (ex post), and over the total event window. The last two columns indicate whether the results are in line with the shareholder exploitation or cost avoidance hypotheses. (+) indicates that the results support the hypothesis, (-) indicates that the results refute the hypothesis, and n.s.s. stands for not statistically significant.

Study	Sample period	Selection criteria	Event window	Sub sample	Sample size	CAARs			Hypotheses	
						Total event window	Ex post	Ex ante	Cost-avoidance	Shareholder-exploitation
Dodd and Leftwich (1980)	1927-1977	NYSE listed firms	[-5,+5] (years)	All	140	+33.5%	-2.6%	+36.2%	(+)	(-)
			[-2,0] (years)	Exclude co with highest CAR	139	+5.4%	-	+5.4%	n.s.s.	(-)
Romano (1985)	1960-1982	NYSE or AMEX listed companies at time of reincorporation	[-99,+99] (days)	All motives	150	4.10%	-0.40%	4.50%	n.s.s.	(-)
				Takeover-defence motive	43	1.30%	-0.60%	1.90%	n.s.s.	(-)
				M&A motive	63	8.60%	1.70%	6.90%	(+)	(-)
				Tax and other motive	44	0.60%	-3.20%	3.80%	n.s.s.	(-)
Peterson (1988)	1969-1984	US reincorpo-rations of NYSE listed firms	[-30,+10] (days)	All motives	30	1%	+1.5%	-0.5%	n.s.s.	(-)
				Takeover-defence motive	14	-1.7%	+0.4%	-2.1%	(-)	n.s.s.
				No takeover-defence motive	16	+3.4%	+2.5%	+0.9%	(+)	(-)
Netter and Poulsen (1989)	1986-1987	NYSE or AMEX listed firms	[-20,+5] (days)	All	36	+5.7%	-	-	(+)	(-)
				>5% insider ownership	25	+6.4%	-	-	(+)	(-)
				≤5% insider ownership	11	+4.0%	-	-	(+)	(-)
				From California	19	+6.4%	-	-	(+)	(-)
				Not from California	17	+4.9%	-	-	(+)	(-)
Heron and Lewellen (1998)	1980-1992	NYSE, AMEX or OTC traded firms (excl. firms with share prices < $3, and firms traded less than 70% of sample period)	[0,+5] (days)	All	294	-0.1%	-0.1%	-	(-)	n.s.s.
				Takeover defence motive	54	-1.7%	-1.7%	-	(-)	(+)
				Takeover defence among motives	168	-0.8%	-0.8%	-	(-)	(+)
				Limited liability only motive	59	+2.0%	+2.0%	-	(+)	(-)
				Ltd liability among motives	165	+0.8%	+0.8%	-	n.s.s.	(-)
				Ltd liability nor takeover defences as motive	49	-1.2%	-1.2%	-	(-)	n.s.s.

Table 3: Value effects of a Delaware incorporation

This table provides an overview of the studies on the impact of a Delaware incorporation on a firm's value (as measured by Tobin's Q) and on the likelihood of a takeover bid. The table shows the sample period and size, the dependent variable, and its relationship with a Delaware incorporation. The last two columns indicate whether the results are in line with the shareholder exploitation, or cost avoidance hypotheses. (+)indicates that the results support the hypothesis whereas (-) indicates that the results refute the theory. N.s.s stands for a not statistically significant relation. ***, **, * indicate the significance within the 1%, 5%, and 10% levels, respectively.

					Hypotheses	
Study	**Sample period**	**Sample size**	**Dependent variable**	**Delaware incorporation**	**Cost-avoidance**	**Shareholder-exploitation**
Daines (2001)	1981-1996	39,515	Tobin's q	0.073***	(+)	(-)
		3,529	Likelihood of a hostile takeover bid	0.35***	(+)	(-)
Subramanian (2004)	1991-1996	24,470	Tobin's q[3]	0.022***	(+)	(-)
		50,776	Likelihood of a hostile takeover bid	0.461**	(+)	(-)
	1997-2001	24,434	Tobin's q[3]	0.0034	n.s.s.	(-)
		48,624	Likelihood of a hostile takeover bid	0.107	n.s.s.	(-)
Bebchuk and Cohen (2003)	1999	5,340	Probability of a Delaware incorporation	-2.00E-05	n.s.s.	n.s.s.

Table 4: Anti-takeover legislation and the US reincorporation decision

This table provides an overview of the studies focusing on the relationship between a state's anti-takeover legislation and (re)incorporations. The table shows the sample period, selection criteria, sample size , the dependent variable, and the relationship between this dependent variable with the quality of the anti-takeover defenses of the headquarters state, the current state of incorporation, and the most likely alternative state of incorporation. The last two columns indicate whether the results are in line with the shareholder exploitation or cost avoidance hypotheses. A (+) indicates that the results support that hypotheses whereas a (-) indicates that the results refute the theory.

Study	Sample period	Selection criteria	Sample size	Dependent variable	Quality of the anti-takeover defences is high in:			Hypotheses	
					Alternative state of incorporation	State of current incorporation	Headquarters state	Cost-avoidance	Shareholder-exploitation
Subramanian (2002)	2000	All US listed co's (excl. financial co's)	5,768	Incorporation in Delaware			(-)	(-)	(+)
				Incorporation in some other state			(-)	(-)	(+)
	1991-2000	idem	5,598	Probability of reincorporation in best alternative state of incorporation	(+)	(-)		(-)	(+)
Bebchuk and Cohen (2003)	1996-2000	idem	5,323	Fraction of local firms incorporated in the state			(+)	(-)	(+)
			50	Log of (1+number of out-of-state incorporation)	(+)			(-)	(+)

Table 5: Cross-listings and the bonding hypothesis

All the studies below measure corporate governance quality by La Porta et al.'s (1998) anti-director rights index.

Study	Sample period	Sample size (cross-listings in the US)	Number of countries	Dependent variable	Effect of home market's corporate governance quality	Main results
Reese and Weisbach (2002)	1985-1999	11,196 (11,196)	48	Probability of a US cross-listing (ADR II or III)	+	Firms from countries with strong corporate governance standards are more likely to cross-list via a Level II or III ADR
		454 (454)	48	Equity issues after a cross-listing (ADR II or III)	–	Firms from countries with weak corporate governance standards do more equity issues outside the US subsequent to Level II and III ADR cross-listings
Doidge (2004)	1994-2001	138 (76)	20	Voting premium (ratio of price of voting right to cash flow right)	–	Voting premiums are lower for firms cross-listing via Level II or III ADRs; the reduction in the voting premium higher for firms from countries with weaker corporate governance standards
Doidge et al. (2004)	1997	778 (778)	40	Tobin's Q	–	Firms from countries with weaker corporate governance standards have a higher cross-listing premium
Lel and Miller (2006)	1992-2003	1318 (1318)	42	CEO turnover	–	Firms from countries with weak corporate governance standards observe higher CEO turnover after cross-listing
Doidge et al. (2006)	1995-2001	4516 (398)	31	Probability of a US cross-listing (Level II or III ADR)	–	Probability of a US cross-listing decreases with the stake held by corporate insiders and the difference in control rights and cash flow rights held by the largest shareholder
Abdallah and Goergen (2008)	1990-2000	175 (NA)	18 home markets, 19 host markets	Improvement in investor protection	–	Firms from countries with weaker investor protection are more likely to cross-list on stock markets with significantly higher investor protection